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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of	)	
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Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	

COMMENTS OF MFS COMMUNICATIONS COMPANY, INC.

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Summary

In this docket, the Commission has invited parties to comment broadly on the goals of price cap regulation, the need for short-term ("baseline") changes in the LEC price cap plan, and the desirability of longer-term ("transition") changes in regulation that would become effective if and when greater competition develops in LEC markets.

MFS believes that, although the basic goals of price cap regulation are sound, the Commission should give greater emphasis to the goal of preventing unreasonable discrimination and preferences; and also should recognize that the introduction of effective competition in LEC markets is a highly effective means of promoting its underlying policy goals of reasonable and nondiscriminatory rates, infrastructure development, and economic growth. The current price cap rules lack sufficient safeguards against LEC discrimination, cross-subsidization, and anti-competitive behavior. The risk of these behaviors will *increase*, not decrease, as the transition to local exchange competition begins, and regulatory scrutiny of LEC pricing during the transition period will therefore remain critical. The ultimate objective of the Commission's policies, however, should be to promote *effective* competition so that LEC prices and service quality can be constrained by market forces rather than regulation.

Based upon these policy concerns, MFS proposes three primary changes in the "baseline" price cap plan for LECs. First, the existing system of pricing categories and subindexes in the trunking basket should be replaced by a cost consistency test. The existing system has led to perverse results in the trunking basket. In some cases, services

that use comparable facilities are placed in different categories (*e.g.*, DS1 and DS3), which allows the LECs to preserve historical rate structures that are completely out of line with costs. In other cases, the fact that a variety of services are combined in the same category (*e.g.*, basic DS3 circuits and various volume and term discount options for large users of DS3 services) can permit the LECs to move rate levels even farther away from cost-based relationships in order to further strategic, anti-competitive goals. Both of these problems could be remedied by replacing the existing system of indexes that only measure price changes (without respect to costs) with a cost consistency test. Cost consistency means that all trunking services would be compared to their underlying direct (long-run incremental) costs; LECs would be allowed the flexibility to increase or decrease rates for individual rate elements as long as the price-to-cost ratio for each rate element remains within 10 percent of the average ratio for the basket.

The Commission should reject the alternative suggestion presented in the *Notice* for realignment of price cap baskets and service categories based upon the perceived or expected level of competition faced by particular services. This is an inherently subjective standard that would invite incredible abuse. In addition, this concept would create the danger of price squeezes if the LECs were permitted to reduce prices for certain "retail" services without being required to make similar changes in the "wholesale" rates for bottleneck rate elements upon which their competitors are dependent.

<u>Second</u>, the Commission should reject LEC proposals to reduce its scrutiny of "new service" costs and prices. The Commission's regulations have not been any

impediment to the introduction of service offerings that incorporate substantially new technology or functionality; to the best of MFS' knowledge, no such LEC service has *ever* been rejected or withdrawn since the introduction of price caps. However, Commission scrutiny has proven reasonably effective in detecting and preventing some of the more egregious LEC schemes to effectuate unreasonably discriminatory and preferential repricings of existing services under the "new service" flag of convenience.

Rather than reduce its scrutiny of "new service" tariff filings, the Commission should enhance its existing review of these filings by requiring the LECs to incorporate new services into their price cap index calculations immediately, based upon projected demand (with quarterly updates to take account of actual demand experience). New services should also be subject to a cost consistency test as described above, and should be compared directly to existing services that use similar underlying network functions and resources.

Third, the Commission should adopt Total Service-Long Run Incremental Cost (TS-LRIC) as the basic cost standard for review of LEC pricing for cross-subsidization and unreasonable discrimination. The existing average variable cost standard for below-band pricing has proven difficult to apply in practice, and economic analysis reveals that the existing standard is insufficient to deter predatory pricing and cross-subsidization. AVC cost studies fail to consider all of the costs incurred by LECs in providing a service and therefore can permit prices that fail to recover all relevant costs. TS-LRIC is a more appropriate cost benchmark for this purpose. TS-LRIC can also serve as the basis for price-cost comparisons between services, as proposed in MFS' cost consistency test.

As it considers "transition" changes that may be implemented as LEC markets become more competitive, the Commission must recognize that no effective competition exists today, or will in the immediate future, for most LEC services. The majority of LEC revenues are produced by basic local exchange services and other intrastate services that are legal monopolies of the LECs in many jurisdictions, and are *de facto* monopolies in the remaining jurisdictions because of numerous economic and technical barriers to entry. Because the LEC networks use shared and common facilities and resources to produce both monopoly and transitionally competitive services, the introduction of pricing flexibility on a service-by-service basis is both illogical and counterproductive. As services that produce a relatively small proportion of the revenues generated by shared and common facilities are opened to competition, the LECs could use pricing flexibility to shift the recovery of shared and common costs to captive ratepayers and gain an undeserved and anti-competitive advantage in the niche markets for the more competitive services. Only when *all* services are opened to competition will this opportunity be eliminated, since at that point market forces will prevent the LECs from demanding an excessive recovery of shared and common costs from any class of customers.

Viewed on a market-wide basis, LECs continue to enjoy a market share of close to 100 percent for basic local exchange and switched access services. Opening these markets to competition will require extensive regulatory action to provide competitors with equal access to bottleneck resources. These bottlenecks include both physical facilities such as rights-of-way, pole attachments, and building entrances, and intangible technical resources such as telephone number assignments, number portability, signalling systems, and information in databases. The Commission should condition any increase in LEC pricing flexibility on the offering of all bottleneck resources to competitors on terms equal to those on which the LEC itself uses them.

The availability of telephone number portability, on terms that do not put the competitive entrant at a revenue or cost disadvantage to the incumbent, is particularly crucial to creating competitive alternatives that customers will find attractive. As one of the conditions for opening markets to competition, the Commission should require that any incremental costs associated with the availability of number portability should be borne by *all* ratepayers on a non-discriminatory basis, not just those customers who elect to be served by a competitive entrant.

Once the conditions for opening markets to full-fledged competition are satisfied, there will still be some transition period before competitors can deploy the necessary facilities and develop advertising and marketing programs so that competitive services become widely available and meaningful alternatives to LEC services. MFS would prefer that the Commission defer LEC pricing flexibility until the availability and usage of competitive services have reached minimal threshold levels within a geographic market; however, MFS recognizes that such a standard would put severe administrative burdens on the Commission. Accordingly, MFS would accept as an alternative a transition plan that would allow LEC pricing flexibility, including customer-specific pricing for interstate services, at a pre-defined time after the conditions for opening a particular study area to competition have been satisfied.

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MFS COMMUNICATIONS COMPANY, INC.

MFS Communications Company, Inc. ("MFS"), by its undersigned counsel, hereby submits its comments upon the Notice of Proposed Rulemaking (the *"Notice"*), FCC 94-10, released in this docket on February 16, 1994.

Introduction

In this proceeding, the Commission has announced its intention to review the results of its three-year experiment with price cap regulation of local exchange carriers ("LECs"), and to consider revising this system of regulation to better achieve the Commission's public policy goals. For the reasons to be explained in these comments, MFS respectfully submits that the goals of price cap regulation and the basic concepts on which this form of regulation is based are sound. Significant changes in the design of the price cap plan are needed, however, in order to align the Commission's regulatory practices with its stated policies, including particularly its policy of encouraging the evolution of a workably competitive local exchange market.

Experience to date has shown that the price cap plan achieves some of its goals more effectively than others. In particular, the plan has worked reasonably well in controlling the *overall* level of LEC prices and earnings. As intended, the LECs have been required to reduce their prices relative to inflation, thereby passing through to consumers the benefits of productivity gains and other efficiency-enhancing actions. The increased earnings reported by many of the price cap LECs demonstrate that the financial incentives provided by price caps do work; the LECs have reduced their costs in order to improve their earnings, and LEC customers have received a benefit in the form of lower overall prices.

However, the price cap plan has been much less effective in regulating the LECs' rate structures, with the result that the benefits of incentive regulation have been very unevenly distributed. The Commission has implicitly recognized this weakness in the price cap plan, because during the last three years it has repeatedly created exceptions to the price cap rules in order to exercise control over LEC rate structures for particular services, including Basic Service Elements introduced under the ONA rules, connection charge elements for expanded interconnection, and restructured local transport rates. Apart from these special proceedings, Commission oversight of LEC rate design has been virtually non-existent since the adoption of price caps. The price cap rules contain multiple loopholes that have allowed the LECs to engage in almost unchecked rate discrimination and cross-subsidization, and to adopt pernicious and anti-competitive pricing maneuvers, such as (but not limited to) unlimited and economically unjustified volume and term discounting of access services. Even where the Commission *has* intervened in LEC pricing, as in the expanded interconnection investigation (CC Docket No. 93-162), the LECs have been able to "game" the process to put competitors at a substantial disadvantage in the marketplace.

These dangers of strategic and anti-competitive actions by the LECs will increase, not diminish, as selected LEC service markets become competitive on a service-by-service basis. The transition to competition is the most precarious stage of market development, because the LECs will still generate the majority of their revenues from captive ratepayers who purchase monopoly services. Because a very large portion of LEC costs are attributable to shared and common facilities that produce both monopoly and transitionally competitive services, the LECs will have ample opportunities to shift costs among these services and engage in cross-subsidization and predation, unless constrained by effective and enforceable regulations.

For these reasons, MFS proposes below certain "baseline" changes to the LEC price cap plan, which should be implemented as soon as possible in order to assure that local exchange competition will have an opportunity to emerge. First, the existing system of pricing categories and subindexes in the trunking basket should be replaced by a cost consistency test. Under this test, all trunking services would be compared to their underlying direct (long-run incremental) costs; LECs would be allowed the flexibility to increase or decrease rates for individual rate elements as long as the price-to-cost ratio for each rate element remains within 10 percent of the average ratio for the basket. Second, rather than reduce its scrutiny of "new service" tariff filings, the Commission should enhance its review of these filings by requiring the LECs to incorporate new services into their price cap index calculations immediately, based upon projected demand (with quarterly updates to take account of actual demand experience). New services should also be subject to a cost consistency test as described above, and should be compared directly to existing services that use similar underlying network functions and resources. Third, the Commission should adopt Total Service-Long Run Incremental Cost (TS-LRIC) as the basic cost standard for review of LEC pricing for cross-subsidization and unreasonable discrimination.

The Commission's ultimate goal should be to create conditions under which market forces, rather than regulation, can effectively prevent LECs from charging unreasonable rates or engaging in cross-subsidization and unreasonable discrimination. For this to occur, however, competition must be widespread throughout a geographic market and must encompass *all* LEC services, including basic local exchange service. Many regulatory actions must occur before these conditions can exist. Nonetheless, if and when LEC bottleneck resources are made available to competitors and legal, economic, and technical barriers to entry fall, MFS agrees that removal of regulatory restrictions on LEC pricing would become appropriate. Although this goal is unlikely to be achieved in the short term, the Commission can begin by setting conditions for opening markets to competition, and offering LECs the incentive of highly streamlined regulation (including allowing customer-specific pricing) once those conditions have been satisfied and a sufficient time has elapsed to permit widespread market entry.

As requested by the Common Carrier Bureau, *see* Public Notice, DA 94-219 (released March 8, 1994), MFS will organize the remainder of its comments as responses to the specific numbered issues set forth in the *Notice*. These comments will, however, only address some of the issues identified in the *Notice;* as a result, the following sections are not consecutively numbered.

General Issue 1: Should the Commission revise the goals of the LEC price cap plan so that the plan may better achieve the purposes of the Communications Act and the public interest, and if so what should be the revised goals?

In adopting LEC price caps in 1990, the Commission stated that its objective was "to harness the profit-making incentives common to all businesses to produce a set of outcomes that advance the public interest goals of just, reasonable, and nondiscriminatory rates, as well as a communications system that offers innovative, high quality services."[1] MFS believes that the Commission's 1990 goals remain valid as a broad general statement of regulatory objectives. MFS' concerns with LEC price cap regulation concern the *means* of achieving these goals, rather than any disagreement with the goals themselves.

Although the Commission should not change its broad statement of goals, it should refine these goals in two significant respects.

First, the Commission should put greater weight on the promotion of "nondiscriminatory" rates than it did in the initial price cap plan. As will be discussed in greater detail below, the initial price cap plan concentrated heavily on regulating the *overall* levels of LEC rates, and gave far less attention to the prevention of unreasonable

[1] *LEC Price Cap Order*, 5 FCC Rcd. 6786, 6787 (1990). Commission decisions cited in the *Notice* will be cited herein using the same short forms of reference.

discrimination through rate structure changes as long as the overall revenues remained within the cap. In part, this was because LECs faced little or no competition within their local exchange territories at the time, so that there were few apparent opportunities for anti-competitive pricing. As competition has developed, however, thanks to this Commission's proactive policy initiatives over the last three years, the system of pricing flexibility bands for multiple service categories and subcategories has proved entirely ineffective in preventing LECs from introducing unreasonably discriminatory, preferential, and anti-competitive price discounts for targeted customers. In its desire in 1990 to promote greater LEC pricing flexibility as an incentive to greater efficiency, the Commission failed to take adequate measures to prevent the use of that flexibility to engage in unreasonable discrimination on a highly selective basis in narrowly-targeted emerging competitive markets. In the discussion of the "baseline" issues in following sections, MFS will propose specific revisions to the price cap plan that would strike a more appropriate balance between these concerns.

Second, the Commission should recognize that the promotion of effective competition is an important means of achieving its regulatory goals, and should therefore adopt rate policies that will not leave local competition stillborn. In the long term, the presence of effective competition will create multiple incentives for LECs to engage in "profit-making" behaviors that promote just and reasonable rates, and will encourage the development of innovative, high quality services.[2] The Commission should therefore seek to apply its price cap policies in ways that are consistent with the development of increased local exchange and local access competition. These policies should seek to prevent the LECs from using their control of essential bottleneck facilities to exclude or impede competition, while also allowing the LECs to respond to customer demand (through changes in price levels and service offerings) in those markets where actual and effective competition may ultimately develop. The challenge confronting the Commission in this docket is how to balance these countervailing policy considerations appropriately.

As discussed in more detail below, experience under the first three years of LEC price caps has shown that the existing scheme lacks sufficient safeguards against unreasonable discrimination, cross-subsidization, and other market abuses by the dominant LECs, given current market conditions in which the LECs still enjoy a virtual monopoly and control substantial bottlenecks. The transition to effective local competition has begun, but it is still in its early stages. (*See* discussion under Transitional Issue 1a, below.) Indeed, as more competition begins to develop in the LECs' core markets, the danger of anticompetitive responses and the need for regulatory vigilance will *increase*, at least during the transitional period.

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[2] These benefits of competition were noted in the *Expanded Interconnection Order*, 7 FCC Rcd. 7369 at paras. 13-14, citing numerous examples from previous Commission policy initiatives to promote competition in various sectors of the telecommunications industry. The Commission has recognized the multiple benefits of competition in many other contexts, as well. *See, e.g., AT&T Price Cap Order*, 4 FCC Rcd. at 2886, para. 25; *Competitive Carriers*, First Report and Order, 85 FCC 2d 1, 2 (1980); *MTS & WATS Market Structure*, 81 FCC 2d 177, 202 (1980).

At least two forms of potential anticompetitive conduct require special attention during the transition to competition. First, the LECs must be prevented from refusing or providing access to *essential facilities* that they control on terms comparable to those on which the LEC provides its own end users with the use of those facilities. Inferior access may include higher prices, lower technical quality, delayed installation, or other actions that make it more difficult or more expensive for a competitor to obtain access to the essential facility than it is for the LEC itself to use that facility. The essential facilities controlled by the LECs are discussed in more detail under Transitional Issue 1d, below.[3] The Commission has recognized this danger in many recent decisions,[4] but the price cap rules generally fail to incorporate any meaningful safeguards against this type of abuse. Rather, as previously noted, the Commission has been forced to prescribe special pricing rules outside of the price cap structure in several instances where access to essential resources was at issue.

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[3] The essential facilities controlled by the LECs include both physical resources that cannot be duplicated at reasonable cost, such as pole attachments, underground conduits, and common facilities within multi-tenant buildings; and intangible resources such as signalling codes and telephone numbers, which are essential to the provision of competitive services. This issue is discussed in more detail under Transitional Issues 1a and 1c, below.

[4] *See, e.g., Filing and Review of Open Network Architecture Plans*, 4 FCC Rcd. 1, 11 (1988) (requiring ONA tariffs as a precondition to removal of structural separation to prevent "anticompetitive conduct based on BOC control of underlying, local communications networks"); *Expanded Interconnection Order*, 7 FCC Rcd. at 7406 (rejecting LEC arguments that only broad guidelines are required for collocation, finding that such broad LEC discretion in establishing collocation arrangements likely would result in "substantial delay"); *Ameritech Operating Companies*, 8 FCC Rcd. 4589 (1993) (finding that most LECs failed to justify overhead loadings in setting rates for expanded interconnection, and partially suspending rates that appeared excessive); *Local Exchange Carriers' Rates, Terms and Conditions for Expanded Interconnection for Special Access*, 8 FCC Rcd. 8344 (1993) (finding LEC expanded interconnection rates to be unlawfully excessive, and prescribing maximum overhead loadings on an interim basis).

Second, the LECs must be constrained from engaging in undue discrimination between those customers who may have effective competitive alternatives and those who do not, based solely on this factor.[5] Explicit discrimination of this type, of course, is relatively easy to detect and prevent. The Commission has, for example, prevented the LECs from engaging in customer specific pricing of access services in most circumstances;[6] it also has carefully restricted geographic zone pricing and other forms of rate deaveraging to assure that these are not used as vehicles for unjust discrimination.[7] A more serious problem exists, however, with the use of other tariff mechanisms to disguise unjust discrimination that harms captive customers.

Services in the "trunking" basket, in particular, have been vulnerable to these abuses. The LECs have developed a series of "flags of convenience," including open-ended volume, term, and capacity discounts, "new" services that are really repriced versions of old services, and special construction, that have allowed them to evade price

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[5] MFS is not opposed, in principle, to rate structures that differentiate among customers based upon relevant cost-related factors such as geographic location, transmission capacity, and so forth, as long as all similarly-situated customers can obtain service on the same terms. There is, however, a danger that these types of rate structures can be abused, by creating price differentials that are excessive relative to the underlying cost differentials, to grant undue preferences to certain customers perceived by the LEC to be at "competitive risk," and thereby to impose excessive and unreasonable prices upon the remaining ratepayers.

[6] *Local Exchange Carriers' Individual Case Basis DS3 Service Offerings*, 4 FCC Rcd. 8634 (1989) (requiring replacement of DS3 ICB arrangements with averaged, tariffed rates), and 5 FCC Rcd. 4842 (1990) (ordering four LECs to replace dark fiber ICB arrangements with averaged, tariffed rates). *See also Southwestern Bell Tel. Co., Revisions to Tariff F.C.C. No. 73*, Transmittal No. 2297, DA 94-204 (released March 4, 1994); *Southwestern Bell Tel. Co., Revisions to Tariff F.C.C. No. 73*, Transmittal No. 2316, DA 94-354 (released April 15, 1994).

[7] *See Expanded Interconnection Order*, 7 FCC Rcd. at 7454-57.

cap review and offer steeply discounted rates to a few carefully selected, favored customers. As these so-called "new" offerings are incorporated into existing price cap service categories and subindexes, the LECs gain the ability to shift costs between these preferred customers and the captive ratepayers who buy other services within the same category or subindex. Rate relationships *within* an individual category or subindex currently can be changed without limit as long as the overall category or subindex remains within band, which results in rate structures that bear no resemblance whatsoever to the underlying cost structure.

When the Commission adopted price cap regulation, it specifically cautioned the LECs that, even if tariffs comply with the price cap indexes and bands, they could still be subject to the Commission's investigation and complaint processes for the prevention of unreasonable discrimination.[8] In practice, these processes have proven inadequate to prevent or even deter unreasonable discrimination by LECs. Especially within the trunking basket, LECs have been able to change rate *structures*, not just rate levels, virtually at will and their tariffs have been investigated only in those few cases where the Commission had the foresight to prescribe specific pricing requirements outside of the standard price cap rules. The only other remedy theoretically available to parties injured by anti-competitive LEC pricing, a Section 208 complaint, has proven unworkable and unsatisfactory in practice due to the limited scope of discovery available, the many

[8] *LEC Price Cap Order*, 5 FCC Rcd. at 6822, paras. 291, 293-95.

procedural delaying tactics used by defendants, and the extremely lengthy time required for the issuance of decisions.

For these reasons, MFS is proposing herein various "baseline" changes to the price cap plan in order to provide more effective and enforceable safeguards against anticompetitive tactics. These safeguards are intended to serve the same purposes as the original goals of the Commission's price cap plan, but to do so more effectively than the existing scheme. At the same time, however, MFS recognizes that the promotion of *effective competition* as a policy goal will require removal of obsolete or unduly restrictive regulatory restraints from the LECs at such time as they face tangible and quantifiable competition in the local exchange markets where they now enjoy complete or nearly complete monopolies. If competitive markets are to operate efficiently and produce consumer benefits, then, at that time, LECs in those markets must have the same flexibility with respect to prices and services *and* the same market incentives (both rewards and risks) as do their competitors; they must not, however, be allowed any anti-competitive advantage such as the ability to recover the costs of services provided in competitive markets through excessive rates to captive customers elsewhere. Therefore, MFS also proposes herein "transition" rules for future changes in the price cap system if and when conditions in a particular market justify it. In particular, although MFS has previously opposed allowing LECs to engage in customer-specific pricing and continues to believe that it would be premature to do so now, it will propose in these comments specific conditions under which LECs could be authorized in the future to employ customer-specific pricing as a legitimate competitive tool.

Baseline Issue 2: Whether the rules relating to the LEC price cap baskets and bands should be revised.

The LEC price cap system groups LEC services and rate elements into a number of baskets, with some baskets further divided into service categories and subcategories. Each basket is subject to an independent price cap (but no floor), while categories and subcategories are subject to both upward and downward banding limits.[9] These rules were designed "to limit, but not eliminate, LEC pricing flexibility."[10] The Commission stated that its goal in creating this system of pricing bands was "to permit incremental changes in prices that will assist LECs in achieving the efficiency objectives at the heart of this proceeding, without subjecting ratepayers to precipitous changes in the prices for LEC services, and without enabling LECs to disadvantage one class of ratepayers to the benefit of another class."[11] As will be discussed in more detail below, this goal can be achieved *only* if the Commission is reasonably confident that all ratepayers for services combined in a single category share sufficiently common characteristics to constitute a single indistinguishable "class."

Currently, LEC rates are grouped into four baskets: common line, interexchange, traffic sensitive, and trunking. Until very recently, the four baskets corresponded to the major cost allocation categories established under the Commission's Part 69 rules for

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[9] The rules pertaining to service categories and subcategories are essentially the same; therefore, MFS will refer only to "categories" in the following discussion unless a distinction between the two is required.

[10] *LEC Price Cap Order*, 5 FCC Rcd. at 6810, para. 198.

[11] *Id.* at 6810-11.

purposes of rate of return regulation. This system was modified in the *Second Transport Order* by moving switched transport services from the traffic sensitive basket to the former special access basket, which was renamed "trunking." The Commission concluded that this realignment was justified because "transport elements are more closely related to similar special access services than to local switching and the other services remaining in the traffic sensitive basket, for purposes of determining the scope of LEC pricing flexibility within the price cap rules."[12]

The Commission has also modified the system of service categories and subcategories since the initiation of price caps. Initially, the traffic sensitive basket was divided into four service categories, and the special access basket was divided into four service categories, one of which (high capacity/DDS) contained two subcategories. Subsequently, as a result of the introduction of zone pricing in the *Expanded Interconnection* docket and the restructuring of local transport, the trunking basket now contains six service categories plus two subcategories, and those LECs that institute zone pricing must compute twelve additional subindexes (a subindex must be determined for each of four groups of services in each of the three density zones). This proliferation of indexes has occurred because the Commission has recognized the potential for undue discrimination resulting from unfettered LEC pricing flexibility, especially in those markets that are

[12] *Second Transport Order*, FCC 94-9, para. 12. The Commission stated that this "determination follows logically from" past findings that special access and transport "'use essentially the same underlying facilities,'" and also noted that the realignment would prevent cost-shifting between transport and the other services in the traffic sensitive basket, "which are subject to much less competition at this time." *Id.*, quoting *Transport Order*, 7 FCC Rcd. 7006, 7028, 7034, paras. 42, 53.

beginning the transition from monopoly to competitive, and has sought to adapt the existing pricing flexibility rules to limit such discrimination.

Unfortunately, the Commission's attempt to limit discrimination through pricing bands has proven inadequate, and has provided the LECs multiple opportunities to thwart emerging local competition.[13] The current rules create two countervailing problems, each of which threatens the achievement of the Commission's policy goals of encouraging economic growth. The first is that, to the extent that existing rates reflect historical price relationships based upon the costs of obsolete technologies (or were never cost-based in the first place), the pricing bands can prevent the LECs from moving rates closer to cost. An example is provided by the DS1 and DS3 subindexes—even though DS1 costs have been dropping rapidly with the deployment of fiber optics, the LECs have been required (quite willingly) to maintain obsolete rate relationships that give undue and disproportionate preferences to large customers who use DS3 circuits. In effect, the DS3 customers have received the benefit of cost savings that are actually attributable to changes in DS1 technology, while smaller DS1 customers (who have fewer competitive options) have been put at a relative disadvantage.

The second problem with the existing system is that, where a variety of different services are grouped in a single category, the LECs are free to move *away* from cost-based rates by changing the intra-category price relationships. The DS3 subindex again

[13] The inadequacy of price cap baskets and bands in preventing LEC discrimination and in promoting cost-based rates has recently been identified by several interexchange carriers in petitions for reconsideration of the *Second Transport Order*. *See* CC Docket No. 91-213, Petitions for Reconsideration filed by Sprint Communications Company, WilTel Inc., and Competitive Telecommunications Association (April 4, 1994).

provides an example. The LECs have repeatedly created new rate elements within this subindex by establishing new and increasingly extreme volume and term discount options. This permits them to grant preferential prices to favored customers that are not justified by cost differentials.

In the *Notice*, the Commission inquires whether the basket/category structure should be changed, as proposed by some LECs, to group services based upon "expected levels of competition for LEC interstate services, or other relevant common characteristics." *Notice*, para. 42. This proposal, however, would not eliminate the potential for unreasonable discrimination identified above and would, in fact, likely make matters worse. The "expected level of competition" is precisely the *wrong* basis upon which to designate pricing categories. This is an inherently subjective standard that would be subject to unimaginable LEC interpretation and manipulation. Services should be assigned to baskets and categories based upon objective, cost-related criteria, as the Commission did in assigning switched transport to the trunking basket based upon the fact that this service uses the same facilities in the same way as special access service. If switched transport and special access elements are subject to similar competitive pressures, it is *because* they are functionally comparable services. If two other services that are functionally *dissimilar* happen to be subject to similar levels of competition by coincidence (*e.g.*, common line and local switching, both of which face little if any competition), this would not justify grouping them in a single price cap category.

There are two dangers in grouping services on the basis of perceived market conditions rather than functional characteristics. First, many LEC services depend upon access to essential facilities such as interconnection to LEC central offices. Although a "retail" service such as DS1 special access or DS1 switched transport may be subject to some modicum of competition, competitors often must purchase "wholesale" interconnection elements from the LEC on a non-competitive basis. If services were grouped based on the level of competition, "retail" DS1 services might be placed in a service category with a variety of other competitive services, while "wholesale" interconnection elements would be placed in a different category, perhaps with other bottleneck rate elements. This structure could (unless other safeguards were in place) permit the LEC to reduce sharply its retail DS1 rates while taking offsetting increases in other rates in the "competitive" category, but would not require any similar reductions in the wholesale interconnection rate elements. Competitors could thereby be subjected to a price squeeze by the LEC because of its exclusive control over the bottleneck interconnection elements.

Second, customers could be subject to undue discrimination if services with similar functional characteristics are placed in different categories based upon differing levels of competition. Again, the LEC would have the opportunity to reduce rates for one group of customers by taking offsetting increases in other services within the same category, or to increase rates for the "captive" customers by taking offsetting decreases for other services. This could result in disparate rates for similar services, with some customers being subject to excessive or unreasonable charges solely because of the absence of competitive alternatives for their service.

Of course, the dangers described in the two preceding paragraphs could be minimized by creating rate flexibility bands for each rate element or each distinct service;

that would prevent the LECs from increasing selected rate elements and taking offsetting reductions in other rate elements in the same category. But the Commission has previously rejected this element-by-element banding approach as unnecessarily burdensome for the LECs.[14] Moreover, rate element banding would only slow down the process of creating a price squeeze or rate disparity (since the pricing band would limit the amount by which a rate element could be changed in each year), not prevent it, especially if selective below-band reductions continued to be permitted. And, while rate element banding would alleviate the problem of non-cost-based rates resulting from changes in *intra-category* price relationships, it would probably aggravate the countervailing problem of freezing *existing* non-cost-based price relationships in place.

In short, neither the existing system of baskets and bands nor the alternatives proposed by some LECs provides a satisfactory answer to the problem of undue discrimination. As mentioned above, this problem is most acute within the trunking basket. MFS therefore proposes that the Commission *replace* the existing system of service categories, subcategories, and subindexes in the trunking basket with an alternative system based on the notion of **cost consistency**. Under this proposal, the trunking basket would have only one service category, for the transport interconnection charge (with the same zero upward pricing flexibility as under the present rules), and three zone pricing subindexes where applicable (one subindex for all rate elements, except the interconnection charge, in each of the density zones). The overall price cap for the basket

[14] *LEC Price Cap Order*, 5 FCC Rcd. at 6813, para. 222.